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C O N F I D E N T I A L SECTION 01 OF 03 BAKU 001531

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DEPT PLEASE PASS TO USTR FOR SHAUN DONNELLY, BETSY HAFNER  
AND PAUL BURKHEAD  
NSC FOR MATT PALMER  
GENEVA FOR AMBASSADOR ALLGEIER  
TREASURY FOR CLAY LOWERY, NANCY LEE AND JEFF BAKER  
USDOC FOR U/S LAVIN

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SUBJECT: WTO AMBASSADOR ALLGEIER DISCUSSES WTO MEMBERSHIP  
AND ECONOMIC REALITY WITH LOCAL IFI REPRESENTATIVES

REF: BAKU 1367

Classified By: AMBASSADOR ANNE E. DERSE PER REASONS 1.4 (B, D)

11. (C) SUMMARY: Over dinner October 15 with visiting U.S. Ambassador to the World Trade Organization Peter Allgeier, representatives from four international financial institutions agreed that economic reform was critical for Azerbaijan's future and that the WTO accession process could advance the reform agenda. Ambassador Allgeier told the group that Azerbaijan could leverage the WTO membership process to "lock in economic and political reforms." The IFI representatives stated that GOAJ efforts to advance toward WTO membership were slow and, in order to convince the GOAJ of the advantages of the WTO, the international community needs to identify "key allies" in the government who stood to gain from membership, and to "build alliances within the system." One of the largest challenges facing the GOAJ and its efforts to join the WTO was the current system of "franchises" in which the economy is divided up into many different pieces controlled by powerful political figures. Thus, economic policy reflects these actors' focus on short-term gains, despite long-term economic dangers. IFI representatives noted the GOAJ needs to have both the political will to reform the economy and the need to build up government capacity to implement change. The group discussed the current macroeconomic environment, noting the strength of the energy sector and the weak development of the non-oil sector. Several participants highlighted the risk of political instability and the rise of political Islam if the GOAJ mismanages its oil revenues and economic development.  
END SUMMARY.

GOAJ AND WTO MEMBERSHIP  
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12. (C) On October 15, Ambassador Derse hosted a dinner with local representatives from the European Bank for Reconstruction and Development, World Bank, International Monetary Fund and UNDP in honor of visiting U.S. Ambassador to the World Trade Organization Peter Allgeier. The group stated that Azerbaijan was still several years away from joining the WTO membership and needed to implement wide-ranging economic and legislative reforms to qualify for membership. The two main challenges to WTO membership were

the lack of political will and the lack of capacity within the government to enact changes. Despite the Presidential Decree of August 2006 that outlined the time-line by which the GOAJ would reform its economy and amend legislation for WTO membership, some of the dinner group questioned the government's intentions. Ambassador Allgeier stated that joining the WTO was a long-term process that would take several years. Allgeier stated that the WTO membership process would enable Azerbaijan to "lock in economic and political reforms." The dinner group agreed that rapid reform is essential to provide Azerbaijan the basis to manage its new oil wealth. They noted that several powerful government officials were aware that the WTO was an organization that "has teeth," unlike other multilateral organizations Azerbaijan has joined, adding that if Azerbaijan violated WTO rules it could be faced with hard economic and political decisions.

13. (C) Dinner participants briefed Ambassador Allgeier on GOAJ efforts to join the WTO and on the importance for the GOAJ to pursue WTO and reform multiple economic sectors in order to avoid political and macroeconomic instability. Several participants noted that WTO membership did not appear to be on the top of the government's agenda and that the Government of Georgia during the late 1990s had worked harder to join the WTO. Ambassador Derse stated that the message to the GOAJ, and in particular to President Aliyev, needed to highlight the "political advantages" of joining the WTO. All agreed that the international political advantages of "joining the club" had resonance with President Aliyev, who wanted to be taken seriously on a global level. Some stated that even with the president's political will, efforts to advance WTO efforts would be difficult due to entrenched

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economic forces.

14. (C) Dinner participants told Allgeier that to convince the GOAJ of the advantages of the WTO he would need to identify "key allies" in the government that stood to gain from membership and to "build alliances within the system." Dinner participants noted that current GOAJ economic policy reflects the interests of influential actors seeking short-term gain despite long-term economic dangers. Several participants noted that the Customs Committee in particular would stand to lose the most and thus would be the most resistant to change. One participant estimated that once the GOAJ accelerated the WTO process, it would still need at least three to five years to implement all the necessary requirements, such as amending current legislation, and would be ready to accede by 2010 or 2011 at the earliest.

"FRANCHISE SYSTEM"

15. (C) The dinner participants highlighted the need for structural economic reform, moving away from the current "franchise system" and towards a more open and transparent liberal economy. In the current "franchise" system, as explained by several IFI participants, the economy is dominated by different economic franchises, with powerful political figures controlling vast economic resources. The franchise system extends throughout the economy and ensures that all participants profit, including the highest government officials. For the GOAJ to reform the economy in preparation for WTO membership, several dinner participants said there needed to be an internal GOAJ dialogue led by the president on how to break up the franchise system. Such a dialogue would be difficult for the president over the next two years since he relies upon many different political and economic actors for his 2008 presidential bid. After the presidential elections, however, President Aliyev may be in a position to reform the economy and modernize as he looks towards his historical legacy. The WTO accession process could assist President Aliyev in reforming the economy. All agreed that to advance towards WTO membership, there needed

to be a "champion of the WTO" within the government to push the process.

#### ECONOMIC ENVIRONMENT

¶6. (C) Dinner participants told Ambassador Allgeier of an increasingly difficult economic operating environment, highlighting the role of multiple monopolies in controlling the economic system. The non-oil sector, according to the group, was slowly suffocating and the GOAJ did not appear to have a well thought through plan to diversify the economy. The president appears focused on short-term infrastructure projects and public investment development in the run-up to the 2008 presidential elections. In addition, the GOAJ will raise the salaries of 500,000 of the 650,000 civil servants by approximately 75 percent over the next year, in a further political move to win votes. (COMMENT: Higher salaries are needed to fight corruption. END COMMENT)

¶7. (C) Dinner participants discussed the critical role of the banking sector in the country's economic development. One representative noted that several individual banking institutions in neighboring Kazakhstan each had more assets than the entire banking system in Azerbaijan. (NOTE: Azerbaijan's banking sector has approximately USD 500 million in capital.) One participant noted that the state-owned banks, International Bank of Azerbaijan and Kapital Bank, operate as powerful monopolies and dominate the sector, keeping out international financial institutions. International energy companies are informally required to maintain their accounts at IBA, further adding to the bank's dominant role. Of the 44 banks, approximately 10 to 12 mid-size banks operate in a competitive environment. Bank Standard, the family bank of Economic Development Minister Babayev, is one of the fastest growing banks.

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#### POLITICAL ISLAM GROWING INFLUENCE?

¶8. (C) Several of the dinner participants recognized that there appears to be a growth in religiosity in Azerbaijan. A few dinner participants highlighted the risk of political instability and the rise of political Islam if the GOAJ mismanaged its oil revenues and economic development and if the lives of the general population did not improve (REFTEL). Some participants cautioned that in the near-term, political Islam did not appear to be a threat to the GOAJ, noting that after years of Soviet domination when religious activity was prohibited, it was normal for Azerbaijanis to rediscover their religion. According to one participant, in the longer-term, political Islam could develop into a powerful force. Dinner participants believed that Islamic movements, modeled on Hamas, could develop to provide Azerbaijan's citizens with services and assistance that the GOAJ could not or was not willing to provide. One participant warned that a version of political Islam modeled on Iran's brand of Islam could also develop in Azerbaijan if the GOAJ did not manage effectively the economy and public expectations. Some of the participants downplayed the threat of Azerbaijan's increasing religiosity, indicating that it would never be as prevalent or wide-spread as in other Muslim countries.

DERSE